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ABSTRACT

Some approaches to the financial analysis of educational institutions are discussed. Higher education, and education in general, is viewed as a service industry that relies on human effort, and knowledge about human performance is held to be a prerequisite to understanding how changes in budgets affect educational quality. Long-range planning in higher education is essential to financial assessment, and judgment about the relative adequacy of given financial data depends on knowledge of an institution's educational objectives. Indices of educational quality should identify changes in the quality of personnel performance and of practices concerning the curriculum, and careful attention should be given to value-added quality indicators, particularly when student quality and progress are being assessed. All financial accounting should include deflated expenditure data in order to reflect the impact inflation has on real spending. Prevailing accounting and financing practices tend to ignore the crucial role played by capital in educational institutions. The size of available expendable resources is one important aspect for consideration in assessing institutional financial health. A study by Bowen and Minter is discussed, and a list of characteristics of a quality institution is appended. (SW)

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INSTITUTIONAL FINANCIAL ASSESSMENT:

METHODOLOGY AND MEANING.

Hans H. Jenny

INSTITUTIONAL FINANCIAL ASSESSMENT:

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AIR

May 21-25, 1978

by Hans H. Jenny

I. During the last five years, interest in assessing the financial condition of colleges and universities has increased quite markedly. Among the causes for this interest are certainly the violent economic behavior that has characterized the 1970s, the remarkable changes in the revenue and cost structure of educational institutions, and the prospects for significant undergraduate enrollment declines during the forthcoming decade.

These, of course, are very obvious reasons, and it may seem trite to mention them. Financial stress, furthermore, appears to be a chronic affliction from which colleges and universities appear to suffer in the best of times.

Perhaps the new element in the quest for understanding institutional finance is the realization that something rather significant has been happening, that a fundamental realignment within the higher education community is about to take place, and that inherited practices of studying educational finances will not provide us with the correct answers. Since I happen to believe that these propositions are essentially correct, let me proceed to some specifics.

II. Higher education -- and education in general -- belongs to a vast network of human and economic activities encompassed in the name of "service industries" or the "service economy." A central feature of these service industries is their heavy reliance on human effort. Personal service is the center of economic activity in this important and still growing segment of our national and world economy.

This is not the place for a minute dissection of "service industry" economics, but a few highlights must be mentioned because they are basic to one of the major points I want to make. Financial analysis of higher educational institutions is not primarily a monetary concern. Money matters of course, but it does so within the confines of educational plans, programs, and activities. Money, its availability and the lack of it, limits both the nature as well as the scope (in volume and time) of the educational activities that do or can take place.

Although we are beginning to see a change, the traditional mode for delivering education in our colleges and universities are classrooms, seminars, laboratories and, to a lesser degree, a variety of tutorial arrangements for guided independent study and research. Teaching -- in contract to learning -- is a high cost institutional activity, and teaching is the "service" that is being produced, at least according to contemporary economic wisdom.

Because teaching depends on human service it is not only a time consuming endeavor but one that requires a large number of human beings in any given institution. A typical feature of service industries is that when they grow, more human beings must be hired to accomplish the required tasks. Therefore, physical productivity tends to increase rather slowly in comparison to mass production conveyor belt driven economic activity.

However, over time, productivity change of a non-physical type does take place: service industries experience quality change over time. In higher education quality change takes place all the time. Unfortunately, we are not very good at measuring it. To tell the truth, we are awfully backward because most of the time we do not know how to measure it. But we talk about it incessantly.

When we need more money from some of our many funding sources, we tell them that with the aid of their funds we shall be able to improve the "quality of our programs." When they take some of our money away, we pour ashes over our heads and cry that such a funding reduction will wreck the quality of our endeavors. On occasion we can, of course, link changes in funding to changes in quality, but most of the time we lack the necessary tools.

One of the most interesting types of quality change taking place in higher education appears in the curriculum when courses are added or deleted, when more information is added to existing courses or eliminated from them, when teachers improve their teaching skills or when they lose them, and when experienced staff is replaced by inexperienced persons, or vice-versa.

Somewhat more difficult to grasp are the quality changes that occur when the educational level of the students worsens or improves, when student social and personal behavior undergoes alterations that affect the learning environment, and when grade inflation sweeps the country.

If one had the requisite technical instruments, it should be possible to determine whether a given educational institution that has been increasing its price year after year has also maintained or increased the quality of its input or whether -- like the U.S. Postal Service -- it has been charging more and delivering less.

I am not touching on this complex question merely to provide some tongue-in-cheek entertainment since most of us grin wrily when we think about these things. I want to make a few serious points:

1. Financial analysis of educational institutions must focus among other things on the change in quality taking place within them.

2. Institutions should develop their own indices of internal quality against which they can, annually or over long periods, measure their actual performance.

3. These indices of quality should identify changes in the quality of personnel performance and of practices concerning the curriculum.

4. Careful attention should be given to value-added quality indicators, particulary when student quality and progress are being assessed.

5. All financial accounting should include deflated expenditure data in order to reflect the impact inflation has on real spending.

The literature in Institutional Research supports the preceding suggestions and a number of the programs this week deal with aspects of the quality issue.

But let me finish this segment by pointing to a principle it may be worth keeping in mind: it is not a foregone conclusion that increasing money flows will necessarily mean that educational quality is either being maintained or increased; nor do shrinking budgets mean that quality is eroding pari passu. Throwing more salary money at staff year after year may neither worsen nor improve its performance. Until we know something about human performance, we really don't know how changes in budgets affect educational quality.

As for the alleged difficulties in establishing some measures, they may have been over-rated. Each institution has a set of standards that it can articulate. Procedures of staff promotion and hiring are not only well established but frequently very formal. Student quality assessment also is well entrenched. There is the risk of some controversy since consensus may be required, a condition which it may be difficult to achieve.*

III. Later this year, the fourth annual "Study of Financial and Educational Trends in Private Higher Education" will be published by Howard R. Bowen and W. John Minter. To date, the study has been financed by the Lilly

*See Appendix for a format from which an index might be established. The reader is no doubt familiar with other more widely disseminated concepts and procedures.

Endowment; it started as an Association of American Colleges project and now is being sponsored by the National Association of Independent Colleges and Universities. While the study is not yet the final world in "Institutional Financial Assessment," it does represent a mixture of the traditional as well as of some new perspectives.

Bowen and Minter have been exploring ways in which changes in program scope and quality might be reported. If their findings have not uncovered any significant program retrenchment during the four years of their joint effort, this may be partly a reflection of their methodology. They, as we all do, depend heavily on how presidents, deans, and faculty report about what is happening within their respective institutions.

The authors have been sharply criticized for not finding more disasters in the key trend lines. Last year, for instance, they accomplished the nearly unforgivable sin of issuing their report of a reasonably tranquil educational finance scene at the height of Capital Hill hearings on behalf of the Education Bill during which sundry education lobbies tried to paint a dismal picture requiring zillions in new funding lest our worthy endeavors collapse in a heap of rubble.

Howard Bowen is an eternal optimist. And he has good reason for this. As far back as I can remember, after some of us had taken the negative position looking for as many trouble spots as possible, somehow higher education -- public and private -- has survived. Hopefulness has its place in higher education finance studies, if for no other reason than that the available data make it so very difficult to determine what is going on anyway. In the absence of information -- as opposed to data -- we might as well hope for the best. The disasters will show up soon enough.

Well, come to think of it, I do not entirely subscribe to that last statement; but I do believe that within the context of the Bowen-Minter study, an optimistic conclusion about the financial condition of higher educational institutions is justified.

If college and university presidents want Howard and John to conclude that the Garden of Eden is full of poisonous snakes and poison ivy, they will have to learn to answer their questions differently. For instance, if their institutions are in programmatic trouble and heading for financial disaster, they will have to tell us that this is indeed so. When they respond in that affirmative and optimistic fashion, then later read about it and discover that this is not what is happening, whose fault is such alleged misinformation?

I guess what I am coming to is a request for a bit more candor and less double talk. If institutional financial assessment is to produce a reasonably accurate reflection of how things are, candor and realism are needed. Institutions cannot have it both ways and play their public relations game in the midst of an objective analysis conducted by sincere and knowledgeable professionals.

In the absence of indicators to the contrary, when college officials respond to questionnaires and interviews that their programs are doing well, that staff quality is improving, and that the financial condition is at least

stable, all we can do is believe them. We can be skeptical and say to ourselves that they probably have not made a very careful study of their own situation. Some respondents tend to have greater credibility outside their institutions than others. This will influence one's interpretation of a given response. But short of industry-wide standards for evaluating and measuring such things, the best we can probably get is an essentially subjective internal response.

If a response to program quality questions is subjective it does not follow that it need be capricious or frivolous. It may in fact be an accurate assessment of what is happening. Therefore, when Bowen and Minter conclude that the responses received indicate a resilient, adaptable, and non-deteriorating private higher education industry, why should we not believe them?

And if we have reservations, as we must, let us challenge those who have responded to their questions for the manner of their response that leads the authors to their essentially favorable findings.

IV. The Association for Institutional Research has made significant contributions to the art and science of long range planning in higher educational institutions. Earl Cheit concluded a number of years ago that improved financial health in the midst of external economic bad weather may have been a significant outcome resulting from better management and planning efforts.

I believe that long range planning is essential also to the financial assessment proper. Without a knowledge of objectives how can one determine whether financial resources are either adequate or insufficient for the tasks ahead?

Modern college and university accounting is not designed to determine whether an institution has adequate resources for carrying out its functions. About all it does is tell us whether fund balances have increased or decreased, how much of the money is restricted and how much of it is not, and by how much revenues exceeded (or did not exceed) expenditures, if one can find one's way through the thicket of in-and-out transfers which today decorate the bottom half of the statement of current funds revenues and expenditures.

Of course, if you talk to a given institution's finance officer, an answer about adequacy can usually be obtained. The chief finance person tends to be conservative, and if the answers are not too close to the vest, the disclosures would often tend to support an "inadequacy of funds" conclusion. But even finance officers must take care of their public relations image and of that of their institution. So they will probably conclude that they have things under pretty good control.

The true judgement about the relative adequacy (or the lack of it) of a given set of financial data depends upon one's knowledge of a particular institution's educational objectives. Objectives can always be of the blue sky variety. Assuming one can guard against excesses -- and financial tightness does this -- a carefully articulated educational plan containing specific objectives is a requirement if financial assessment is to have meaning. Money

being a means to an end, if the lack of monetary resources prevents essential objectives from being achieved, the financial condition of an institution is not satisfactory, even if the books are balanced (whatever that may mean).

It is therefore my conclusion that sound financial institutional assessment must make logical references to institutional plans and objectives. And my own as yet incomplete research tells me that, in one particular respect, collegiate finance is far more inadequate than the present orthodoxy tends to suggest.

V. In this last segment, I shall limit myself to the independent sector of higher education, although most of what preceded has general application.

One important aspect of institutional financial health centers on the size of available expendable resources. In passing, is it not interesting that this simple datum cannot be ascertained by looking at presently available institutional finance reports? We are allowed to guess, of course, but no one knows for sure. "Does she or doesn't she?"

Every college and university receives over time funds with which it can do as it pleases; it also receives funds for certain specific purposes. This makes for the distinction between "unrestricted" and "restricted" funds. We normally assume that "restricted" funds are not expendable, but this is an inappropriate conclusion. Many "restricted" funds are "expendable."

Since the financial condition of an educational institution is ultimately the responsibility of its governing board, an assessment of what the "expendable" resources are must come from it. As one has been able to observe, depending upon how hard pressed a college is, the term "expendable" is more or less elastic. When you are against the wall, all sorts of things become "expendable" which in less dire times would be considered "unexpendable" capital.

Governing Boards seldom go through the exercise of determinging in advance which available resources would be "expendable" under certain specific circumstances. The general tendency is to deplore it when fund balances decline and to congratulate oneself when they increase.

For endowed institutions, the question of how to fix the proper payout is an interesting problem in conflict resolution. Should you preserve the endowment capital from inflationary erosion? Should you protect the budget against inflationary pressures?

How much capital spending for plant improvement and equipment replacement should be charged to normal current revenues? Should capital consumption be charged to current revenues, and if so, under which kind of formula? Is the capital plan a development matter or should it be part of the total institutional scheme of planned objectives?

The Bowen-Minter studies show so little financial distress probably because prevailing accounting and financing practices tend to ignore the crucial

role played by capital in educational institutions. In some institutions notwithstanding, it is not customary to compensate for endowment capital inflation erosion, and it is not the general practice to require at least a minimum of capital consumption accounting. As a result, current expenditures tend to be understated and available revenues become adequate by default.

A few years ago, those trading in the securities markets discovered that our corporations were still making profits but that earnings per share were not keeping up with the higher rate of inflation. The markets, in their cool and everpresent wisdom reacted logically and wrote down all this hitherto bulled-up wealth to levels that more nearly reflects reality.

Similarly in higher education: if we took a business man's look at collegiate corporate values we would most probably change our assessment of the overall financial condition. It is my professional judgement that with a few exceptions private colleges and universities are woefully underfinanced. They lack "expendable" resources for properly supporting plant and equipment upkeep. Their budgets have been absorbing inflation with almost no increase in real spending for at least five years and longer in some cases. While they are increasing their prices monotonously year after year, the quality of what they are offering may very likely have been decreasing. And their staffs are, again with some exceptions, paying for part of the superficial solvency by taking pay increases that fall short of even matching the rate of inflation.

Worst of all, it appears that private colleges and universities have relatively small "expendable" reserves to be used in the highly probable event of unforeseen future revenue shortfalls or expenditure over-runs. The absence of such reserves is only slightly more troublesome than the prevailing attitude according to which it is deplored when such reserves must be used.

In contrast, let me argue not only that adequate (meaning large) reserves are necessary in the future, and that their periodic drawdown and replenishment will be essential if institutions of higher learning are to maintain the quality of their input (as well as their output). The notion that it is possible to balance one's budget each year presupposes a type of fine tuning that simply is not possible in a world of rapid change and uncertainty. It is showing a lack of perception, to say the least, when one assumes that current revenues must annually match current expenditures.

In order to be financially sound, a private college and university must generate enough resources over time to let it accomplish its stated objectives. Some of this revenue must come in each year, and some can come in over a period of several years. Since it is legitimate to borrow funds for certain projects, long term revenues must be adequate to cover debt over time. Capital renewal also must be included in the long term revenue plan, and if results fall short of objectives, the institution falls behind. Therefore, the issue in financial analysis is not merely the current fund revenues and expenditures plus and minus transfers, but the sum total of money flows into and out of the institution encompassing operations as well as capital requirements.

The "bottom line" is not found in the traditional statement of revenues, expenditures, and transfers, nor is it found in the statement of changes in fund balances.

There is somewhere in all of the financial information a "bottom" bottom line. To date, the industry as a whole has not seen fit to establish a reporting format and a procedure for defining and reporting it. A determination of the appropriate number for each institution requires a reference to its long range financial plan. It also requires a financial policy approved by the governing board that stipulates the conditions under which it believes the institution to be funded adequately.

In this sense, contemporary institutional financial assessment misses the mark because and when it lacks access to policy information against which established financial reports can be tested. The Bowen-Minter studies are beginning to move in the appropriate direction, but private colleges and universities have a long way to go before enough of a consensus exists on just how the problem of measurement should be approached.

In the meantime, higher education is a declining industry showing all the signs of negative growth. But while this is a relatively recent phenomenon to younger observers, the industry never was much of a growth economy prior to the exceptional 1960s. Genteel poverty was the name of the game throughout much of its history. And the chronically depressed condition bred an accounting and financial outlook which never took into account the total needs of most individual institutions.

The Bowen-Minter indicators of financial change look good in part because of what they do not contain: an appropriate comprehensive financial base. I hasten to add that this is not the authors' fault at all. The industry gives itself the wrong base. This is something to reckon with: all available finance data -- in addition to lacking comparability or even compatibility -- are built on only a partial financial base concept. It ignores both inflation and capital requirements and therefore deals with the college and the university as if Providence would take care of the missing pieces.

Strangely enough, Providence has done just that from time to time, and if we are lucky it may come to the rescue again when we need it the most. But in the meantime we may be well advised to help ourselves.

Taking a better look at the limitations of conventional financial statistics and reporting is one such step toward self help. It may eventually go a long way toward reducing the frequency of the double talk that seems to be so fashionable in collegiate circles, proclaiming optimism in one breath and poor mouthing it in the next. Progress might even enhance the industry's credibility with the public, something we shall need when enrollments begin to decline in earnest.

Characteristics of a Quality Institution

Thesis: A private liberal arts college cannot legitimately claim to be an institution of high quality unless the following characteristics are present:

RATING I. The Student Body

With respect to the student body, a quality institution may be one or all of the following:

_____ A. An institution with a selective admissions policy which accepts only those students who are intellectually capable, as measured by board scores, high school rank in class, or other objective evidence of meeting high standards of performance.

_____ B. An institution which encourages its students to grow to their intellectual limits, through a demanding academic program, and which graduates only those students who satisfactorily meet high standards of achievement.

_____ C. An institution which produces graduates who have been prepared to lead full lives and who are capable of making a significant contribution to the solution to human problems.

II. College Personnel

A quality institution would also be characterized by:

_____ A. A superior faculty committed to excellence in teaching and scholarship.

_____ B. A commitment to make adequate provision for the intellectual and professional growth of the faculty.

_____ C. A well-trained and qualified nonacademic staff which is sympathetic to the primary purposes of the institution.

_____ D. Administrative officers who successfully lead the institution toward the realization of its highest potential.

III. Academic Program

_____ A. A quality institution would have an academic program in which each department would have clearly stated objectives, which would be consistent with the mission and goals of the college. The departmental objectives would be regularly measured and evaluated.

_____ B. The academic program would provide a stimulating intellectual milieu and a variety of learning experiences to develop the abilities of the diverse individuals in the student body.

_____ C. A library whose resources support the instructional program and which is used as an integral component of instruction and scholarship.

RATING IV. Student Services

With respect to student services, a quality institution would provide:

____ A. A nonacademic counseling system to assist students in making personal, social, and career decisions.

____ B. A program in which students are afforded the opportunity to develop leadership and interpersonal skills.

____ C. A staff and program which meet the health and safety needs of students.

____ D. A program which enhances the development of the personal, social, and spiritual dimensions of the individual student.

____ E. Cocurricular activities sufficiently diverse and stimulating to encourage a growth in the breadth of a student's awareness and understanding.

V. Facilities

A quality institution has sufficient and appropriate resources in plant and equipment to support the programs and activities that evolve over time in the institution's academic, administrative, and social missions, including:

____ A. Well equipped and modern classroom, computer, studio and laboratory facilities.

____ B. Appropriate living arrangements for residential students.

____ C. Attractive dining facilities for students.

____ D. Athletic and recreational facilities to satisfy a variety of preferences.

VI. Financial Resources

____ A quality institution has sufficient financial resources to insure the continuity of the programs of the College regardless of year-to-year fluctuations in the economic climate, and to permit the development of new programs to respond to the changing needs of its student body. Specifically:

____ A. Adequate current resources to support the academic, administrative, and social programs and activities of the institution by providing adequate budgetary support for the educational and administrative departments, appropriate and sufficient office space and clerical personnel, and timely computer assistance.

____ B. Adequate current and long-range resources to maintain the plant facilities, to acquire new equipment as needed, and to provide for expeditious remodeling and replacement of old plant and equipment.

____ C. Adequate endowment capital development with sufficient current resource investment to support programs and activities designed to enhance the institution's long-range expendable net worth.